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Iran-Iraq:
Gloomy Economic Prospects

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An Intelligence Assessment

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NESA 87-10025
May 1987

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Iran-Iraq:
Gloomy Economic Prospects [redacted] 25X1

An Intelligence Assessment

This paper was prepared by [redacted] 25X1
[redacted] Office of Near Eastern and South Asian 25X1
Analysis. It was coordinated with the Directorate
of Operations. Comments and queries are welcome
and may be directed to the Chief, Persian Gulf
Division, NESA [redacted] 25X1

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Iran-Iraq: Gloomy Economic Prospects

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Key Judgments

Information available as of 1 April 1987 was used in this report.

Lower oil prices, a depreciated US dollar, and over six years of war have put severe pressure on the Iranian and Iraqi economies. Decreased foreign exchange earnings forced both Tehran and Baghdad to slash nonmilitary imports and domestic spending in 1986. Economic difficulties for both countries are continuing in 1987 but will be relatively worse for Iran.

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Even with somewhat higher oil revenues, Iran continues to face onerous financial pressures in 1987. The greatest threats to Iran's economy this year would be an intensified Iraqi air campaign against economic targets or a renewed oil price war. If these do not occur, Tehran probably will maintain its austere import policy because the government is determined to avoid seeking large foreign loans or depleting its foreign assets. Iranian living standards will continue the downward trend of the past three years. Lower imports, declining domestic production, and competition by the military for scarce resources will mean higher inflation and more severe shortages of goods. Political controversy over the degree of government economic control will hamper Iran's ability to cope with these difficulties.

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Unless oil prices fall precipitously again, the Iraqi economy will probably fare relatively better this year than in 1986 because of higher oil revenues, better control of finances, and Iran's inability to effectively attack Iraqi economic targets. Baghdad's sizable debts and continuing military expenditures, however, are a drag on economic performance and require continued austerity. Economic development efforts are stagnant while the regime directs any additional resources toward improving the availability of consumer items.

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Economic conditions will play an important role in the military strategy and political stability of the combatants. Although battlefield victories early this year have bought Tehran some time, Iran must show continuing progress in the war to justify to its populace the enormous human and economic costs of the conflict. Tehran is unlikely to end the war but probably realizes that, unless it redirects resources to the civilian economy, long-term development and political stability will be threatened. There is no chance that Iran can finance a massive buildup of its military arsenal that would threaten Iraq's materiel superiority. Arab financial aid will enable Iraq to sustain essential military and consumer imports. Economic austerity alone is not likely to threaten Iraqi President Saddam Husayn's hold on power in 1987.

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The opposing oil policies of the combatants—Iraq's drive to increase oil exports and Iran's desire to hold down OPEC production—are likely to increase tension among Persian Gulf oil producers. The opening of Iraq's new 500,000-b/d pipeline through Turkey this fall will be a major test of OPEC's ability to maintain higher oil prices. Iran, with little military capability to reduce Iraqi oil exports significantly, probably will seek to exert indirect pressure on Baghdad by threatening its Gulf state backers such as Saudi Arabia and Kuwait. 25X1

Economic problems will probably encourage Tehran and Baghdad to seek better trade relations with the Soviet Union. So far, Tehran has resisted Moscow's efforts to "buy" political concessions—such as discontinuing support for Afghan rebels—and will probably continue to do so. Iraq's need for foreign financing and its dependence on Soviet weapons will continue to encourage strong ties to the USSR, and Iraqi political and economic relations with the United States will probably be slowly rebuilt following setbacks in 1986. There are indications that hard economic times have persuaded Iran to relax its policy on trade with US firms, but this does not represent a basis for a political rapprochement. 25X1

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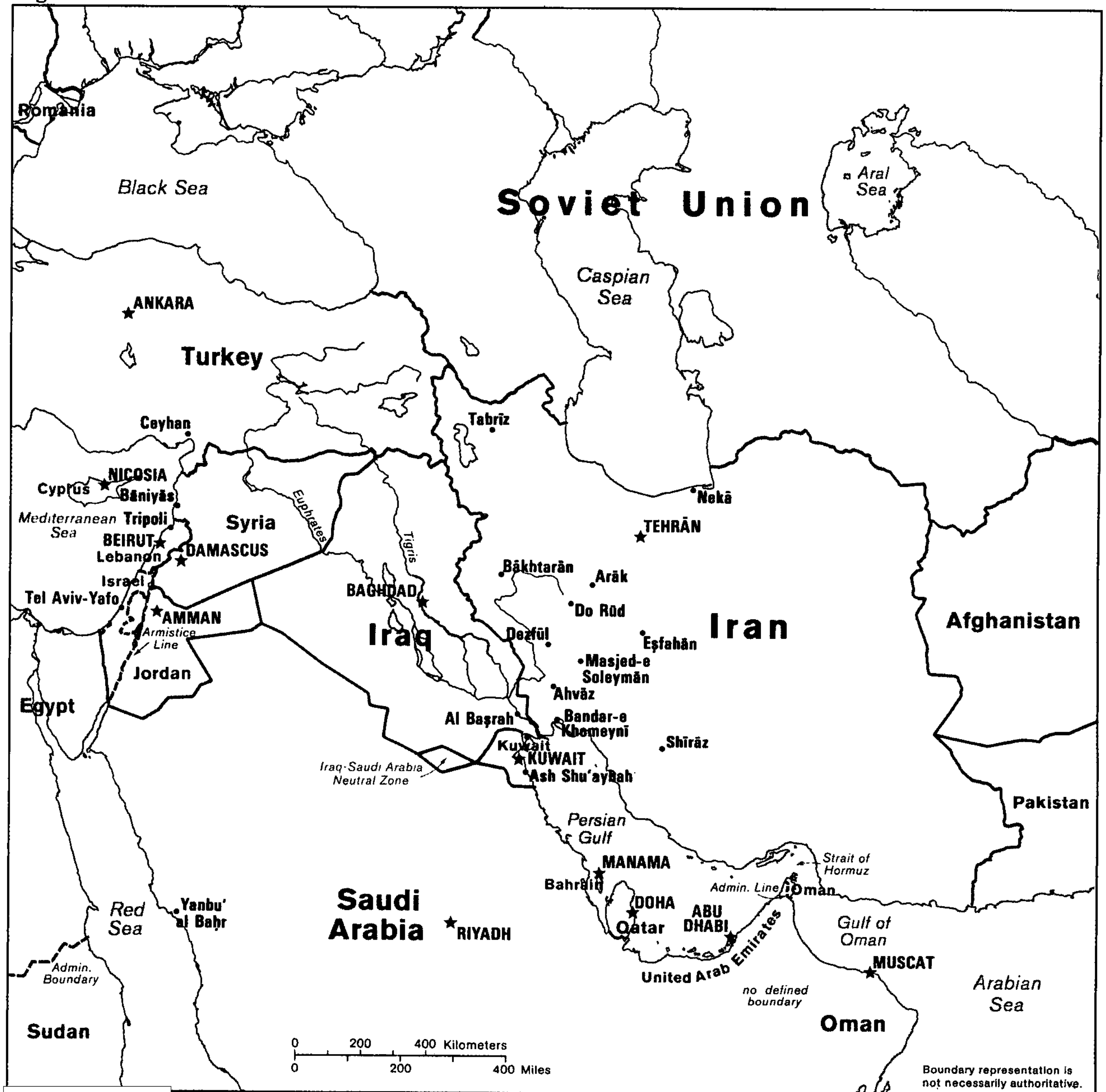
Figure 1



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Iran-Iraq: Gloomy Economic Prospects [redacted] 25X1

Economic conditions are playing an increasingly important role in the political and military strategies of Iran and Iraq. Low oil prices and intensified attacks on economic targets have eroded living standards, aggravating policy disputes within Iraq's Ba'th Party and among competing political factions in Tehran. Economic conditions will be critical to each nation's morale and ability to sustain the war. Military damage to economic targets and continued financial problems also will influence the policies of the two combatants toward the Gulf states, particularly on oil matters. [redacted]

The Iranian Economy in 1986

Lower Foreign Exchange Earnings

In 1986, Iran's economy suffered severe blows from lower oil prices, the depreciated US dollar, and Iraqi attacks against its oil facilities, transport, and other industrial targets. We estimate Tehran's oil export revenues were $7.2 billion in 1986 in contrast to $15.1 billion in 1985. The lower value of the dollar means that the real value of Iran's oil receipts—which are priced in dollars—fell by about two-thirds last year. [redacted]

We estimate Iranian oil exports averaged about 1.5 million b/d in 1986 compared with 1.7 million b/d in 1985. Iraqi attacks had the greatest impact on exports. These included strikes on the Khark Island oil terminal and attacks on shuttle tankers and the oil terminals at Sirri and Lavan Islands. [redacted]

Lower oil revenues forced Tehran to slash imports, draw down its foreign currency reserves, and seek small foreign loans. We estimate Iran cut imports for 1986 by about 25 percent compared with 1985, and imports in 1985 were about 25 percent lower than in 1984. According to Iranian statistics, since mid-1986 Tehran has limited imports almost exclusively to military items, food, fertilizer, agricultural machinery, medicines, and refined petroleum products. Iran drew down its foreign currency reserves in the first six months of 1986 by nearly $1.4 billion, according to data from the Bank for International Settlements, and we estimate that for the year reserves fell by at least $2.5 billion. A reluctant Tehran was also forced to increase its use of short- and medium-term trade credits and seek foreign overdraft credit facilities to finance its current account deficit. [redacted] 25X1

Impact on the Domestic Economy

Lower import levels had devastating effects upon Iran's import-dependent industrial sector and drove up unemployment. [redacted] factory output fell 70 percent in the latter half of 1986 compared with the previous year because Iran could not import sufficient raw materials or spare parts. [redacted] many factories are completely dependent on imported materials, while the industrial sector as a whole imports about 90 percent of its spare parts. According to Iranian Government estimates, industry received only about one-sixth the imports it needs to maintain full industrial production. [redacted]

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[redacted] the Iranian press, reported increasing layoffs in the industrial and construction sectors. On the basis of Iranian press reports, we estimate unemployment is nearly one-third of the 12-million-man labor force, up from official estimates of about 20 percent in 1985. Many of the unemployed were pressed into duty at the warfront. Even government ministries were forced to reduce payrolls by encouraging employees to volunteer for military duty or accept early retirement. [redacted]

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Although basic consumer needs were met, government welfare programs could not shield the urban poor—the backbone of regime support—from a precipitous decline in living standards. Since the revolution, declines in GNP have largely fallen on the

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Economies of Iran and Iraq at a Glance

	Iran	***Iraq***
Population	*48.8 million*	*16.4 million*
Religion (percent)	*Shia Muslim* 93 *Sunni Muslim* 5 *Other* 2	*Shia Muslim* 60 *Sunni Muslim* 37 *Christian* 3
Life expectancy	*54 years*	*56 years*
Literacy (percent)	*48*	*50*
Economy		
Natural resources	*Oil, natural gas, coal, copper*	*Oil, natural gas, phosphates, sulfur*
Agriculture	*Wheat, barley, rice, pistachios, cotton*	*Dates, wheat, barley, rice, livestock*
Major industries	*Crude oil production and refining, textiles, food processing, metal fabricating*	*Crude oil production and refining, light industry, mining*
Gross domestic product per capita	*$1,761 (1986)*	*$2,200 (1986)*
Electric power	*12 million kW capacity*	*6.9 million kW capacity*
Inflation (1987) (percent)	*20 to 25*	*20 to 25*
International Finance		
Important trading partners	*West Germany, Japan, Turkey, Italy*	*Japan, Brazil, France, Turkey, USSR, Italy, West Germany*
Exports (1986)	*Oil: $7.2 billion* *Nonoil: $800 million including pistachios, carpets*	*Oil: $7 billion* *Nonoil: $450 million including dates, natural gas, fruits, and vegetables*
Total external debt	*About $5 billion*	*$17-20 billion*
Liquid foreign assets	*$2-2.5 billion*	*About $1.3 billion*
Current account deficit	*$3.2 billion (1986)*	*$5.25 billion (1986)*

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Figure 2
Major Iranian Economic Targets Attacked by Iraq, May-December 1986

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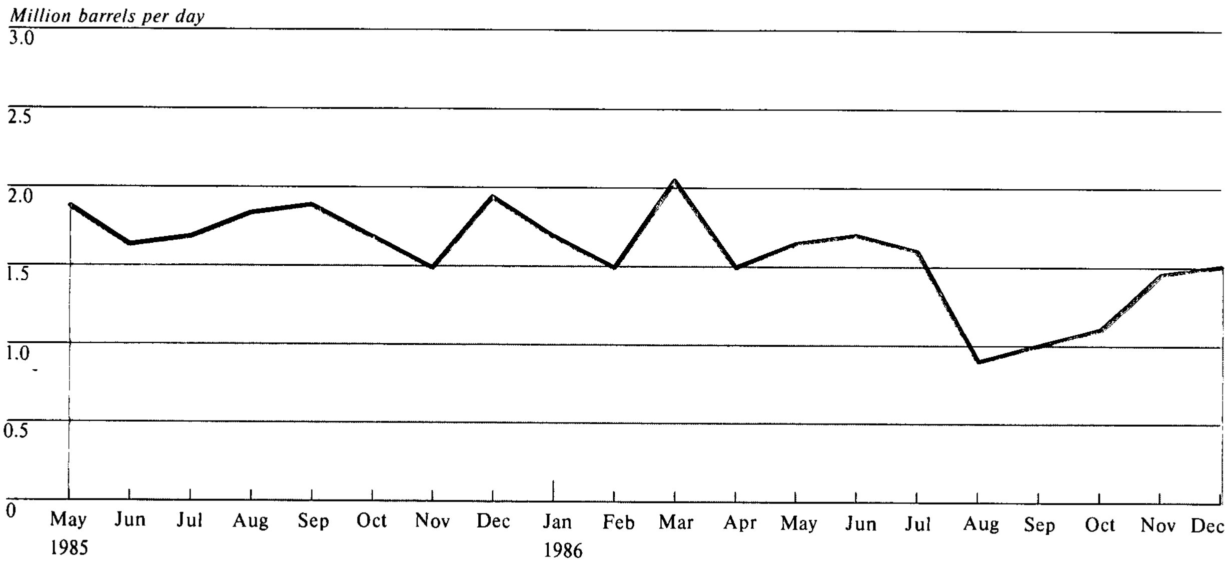
Figure 3
Iran: Oil Exports by Month, May 1985–December 1986



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middle and upper classes, but increasingly the poor are bearing a larger portion of the burden. Wages remained stagnant, but widespread shortages kicked off a surge in inflation. [redacted] black-market prices of many goods doubled in 1986 compared with an overall inflation rate of 20 percent in 1985. Staple food items were in short supply for the first time in years. Many goods became difficult to find even on the black market where previously anything could be had for a price. Items in short supply included cheese, tea, cooking oil, butter, gasoline, soap, paper products, medicines, and school supplies. [redacted]

Iraqi attacks on refineries and other energy-related targets have compounded Iran's economic difficulties. [redacted] all six of Iran's refineries and several pumping stations supplying crude to its three largest refineries were damaged. Traditionally tight domestic supplies of petroleum products were strained by a 50-percent drop in domestic refinery production during the last few months of 1986. Iran was forced to impose gasoline rationing, reduce heating fuel rations by 60 percent, and use scarce resources to purchase petroleum products on the world market. [redacted] Iranian press reports indicated that airstrikes against power stations, combined with shortages of spare parts and technicians, aggravated serious shortages of electricity leading to regular power outages of up to 12 hours a day in Tehran. Other sectors, including the aluminum, steel, military, machine tools, paper, and sugar industries, have also suffered from the air raids. [redacted]

Demonstrations, open grumbling, and disregard for authority increased throughout Iran in 1986 in response to deteriorating conditions. [redacted] crime and antigovernment activity

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in Tehran increased last fall. Demonstrators protesting gasoline rationing blocked thoroughfares and on a few occasions attacked gasoline stations in major cities, [redacted] Revolutionary Guards had to be used to quell some of the demonstrations. [redacted]

The Iraqi Economy in 1986

Revenue Pinch

Low oil prices and the devalued dollar also had harsh effects on Iraq's petroleum-dependent economy in 1986. We estimate that oil production in 1985 25X1 25X1

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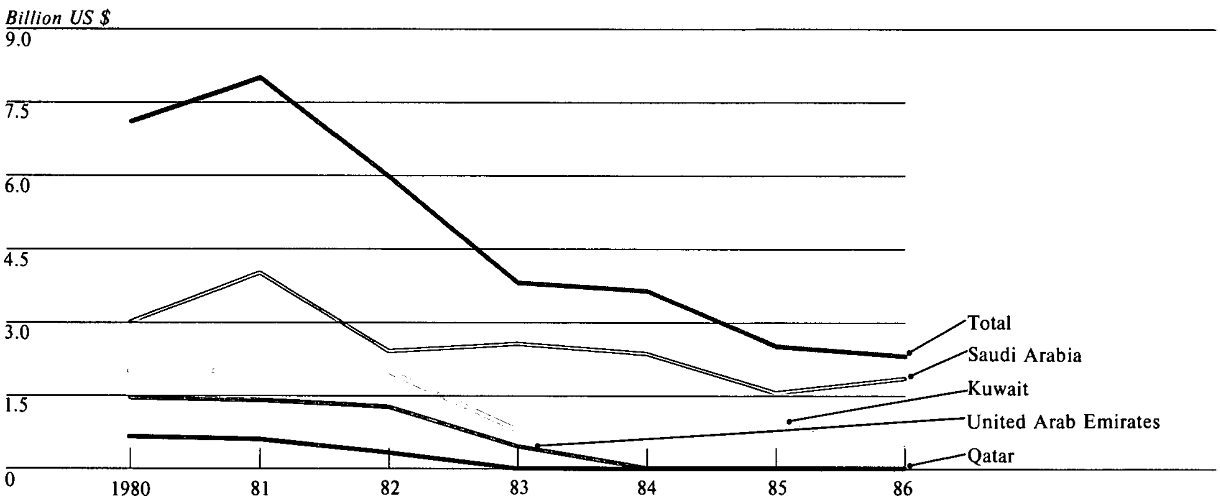
Figure 5
Financial Aid to Iraq, 1980-86



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accounted for nearly half of Iraq's gross national product, and oil profits about 75 percent of government revenues. We estimate Iraqi oil export revenues dropped about 40 percent from $11.4 billion in 1985 to $7 billion in 1986. This occurred despite a 300,000-b/d increase in oil exports to an average of about 1.45 million b/d in 1986. Combined with the fall of the US dollar, Iraq's real foreign exchange earnings declined at least 60 percent in 1986. During the summer months—when oil prices hit bottom—Iraqi oil revenues barely covered military and food imports.

Lower oil prices also put strong budgetary pressures on Iraq's traditional aid donors—Saudi Arabia and Kuwait—making them reluctant to offset Iraq's loss of income. Rather than compensate for Iraq's $4.4 billion decline in oil revenues, Arab financial aid fell slightly. This aid was sufficient to cover only about half of Iraq's foreign currency expenditures on the war. Indeed, we believe the level of such aid in 1986 would have been much lower without some arm-twisting by Baghdad in the second half of the year.

Payment Problems

Baghdad found it difficult and expensive to arrange civilian and military import credits, further tightening Iraq's cash flow. According to press reports, falling confidence in Iraq's financial position and ability to manage its debts caused many banks, official export agencies, and suppliers to restrict credit lines to Baghdad. 25X1

The collapse in oil prices and a bulge in payments due in the spring created a cash-flow crisis. In March, Baghdad stopped payment on several hundred million dollars in short-term trade credits and ignored inquiries from creditors. In retaliation, many commercial lenders stopped issuing letters of credit to Iraq, and suppliers suspended some shipments because of payment arrearages. According to the US Embassy in Baghdad, France—Iraq's second-largest military supplier after the Soviet Union—slowed shipment of weapons and demanded more cash up front because of

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Iran and Iraq: Contrasting Views on Foreign Borrowing

Iraq: Rapidly Rising Debt Burden

The oil price collapse and Iraq's extensive use of foreign loans since the start of the war with Iran have thrust Baghdad into the league of problem debtors. We estimate that Iraq's military and civilian debt totals $17-20 billion, up from about $5 billion in 1979. This amount does not include about $30 billion in "soft" loans from Baghdad's Arab allies, which will not be repaid any time soon. Iraq's debt burden will continue during the next several years as financial pressures force Baghdad to seek additional funds and reschedulings.

Iraq's debt buildup stems from the regime's decision early in the war to substantially increase economic development despite the cost of the war and reduced oil export capacity. To finance development expenditures, Baghdad rapidly depleted its nearly $35 billion in foreign reserves and borrowed from trading partners and its Arab allies. In 1983, when assets ran out, Baghdad was forced to drastically curtail its development program and turn to commercial banks to finance civilian imports. Insufficient foreign exchange earnings have forced Iraq to reschedule a large portion of debt payments each year since 1983.

Iran: Resisting Foreign Borrowing

The government of Ayatollah Khomeini opposes foreign borrowing for religious reasons. Islamic precepts of economic independence and thrift discourage large-scale borrowing. The regime believes that obtaining large loans—especially from the imperialist West—would be viewed as public admission that the revolution is being compromised. After the revolution in 1979, the regime began a deliberate campaign to pay off debts incurred under the Shah. When financial problems became severe, Tehran largely avoided borrowing mostly by reducing imports and drawing on foreign exchange reserves.

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Escalating financial pressures, however, probably are forcing Iran to increase its net borrowing, although disguising it in ways that avoid offending ideologues. The regime is increasing its use of gold swaps—selling some of its gold reserves on a promise to repurchase them later at a higher price—and is using overdraft privileges at several West European and Japanese banks. These borrowings give Tehran access to funds without the publicity of an outright loan.

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missed payments. Iraq's financial management improved somewhat in July following a political shuffle that allowed First Deputy Prime Minister Ramadan to regain economic authority from President Saddam Husayn.

Throughout 1986, Baghdad failed to keep up with payments on its roughly $17 billion non-Arab foreign debt. Iraq was forced to reschedule payment of about $6.2 billion in debt but continued its strategy of bilateral negotiations to gain concessions from some lenders. West Germany, Japan, and France agreed to shift official debt payments due in 1986 to 1988-90. French and Japanese commercial banks rescheduled payments over the next six years. Agreements with Turkey, Yugoslavia, Italy, and India called for a large portion of bilateral debt to be paid in oil.

Austerity

The large fall in oil prices combined with increased fighting in the Iran-Iraq war left Baghdad with little recourse but to abandon its "guns and butter" policy and slash nonmilitary spending. Confusion and political maneuvering within the Iraqi leadership delayed needed austerity measures for several months, but Baghdad started making substantial spending cuts last summer. According to OECD trade statistics, Iraqi civilian imports from OECD countries in the third quarter dropped 32 percent compared with the second quarter. The largest cuts came in development projects, industry inputs, and nonfood consumer items. The US Embassy in Baghdad reports that,

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Ramadan: Iraq's Economic Czar Regains Lost Authority

Initial disagreement among the Iraqi leadership over how to respond to the collapse in oil prices delayed austerity measures and their full impact on the Iraqi people. President Saddam Husayn first created a "Presidential Committee" to make foreign exchange allocations. This undermined First Deputy Prime Minister Ramadan's economic authority—he had long had responsibility for economic decisions—and caused bottlenecks in implementing austerity measures.

Ramadan regained his broad influence over economic decision making at the extraordinary meeting of Iraq's ruling Ba'th Party in July 1986. Saddam—pressed by top party leaders to share more decisionmaking—called the meeting and returned to Ramadan most of the authority that the President had appropriated for himself earlier in the year.

Ramadan's influence stems from his control over Iraq's technocratic elite. His experts in key economic ministries carry on the day-to-day operations of the government and are in charge of strategic economic planning and budgets. These experts play a key role in Iraq's command economy.

The First Deputy has been able to weld these technocrats into an effective political force in Ba'thist politics. According to the US Embassy, when Ramadan imposed his campaign of "working to rule"—he refused to carry out decrees from the Presidential Committee without a direct order from Saddam—activity in the economic ministries practically came to a halt. 25X1

Western diplomatic sources in Baghdad cite additional explanations for Ramadan's success. The feisty First Deputy is extraordinarily bold and ruthless—qualities that impress the extensive contacts in the party that he has developed over a 30-year period. 25X1 25X1

We believe that management of the economy has improved since Ramadan regained economic authority. Saddam, who also was trying to manage the war, could not handle the day-to-day operations of Iraq's finances. Although Baghdad still faces many hurdles, the sense of urgency and confusion that guided Iraqi actions after the oil price fall has been replaced by a more deliberate approach. Ramadan is now leading Iraqi efforts to reschedule more debt and secure new financing. 25X1 25X1 25X1

since late last year, Baghdad has guaranteed the use of foreign exchange only for essential foodstuffs, selected equipment for the petroleum industry, and fabrics for mass-produced clothing. Iraq's private sector—heavily involved in the manufacture and distribution of consumer goods—received hardly any foreign exchange allocations last year,

The Iraqi people quickly felt the sting of the new austerity measures. Consumer goods—particularly food—became more expensive, taxes increased, development expenditures fell, and benefits to government workers were cut. According to the US Embassy in Baghdad, the regime started charging for some medicines it had previously supplied free. Some benefits to military personnel and families of war dead were also eliminated. Rationing of basic foodstuffs was expanded to include other items such as tea and sugar, 25X1 On the basis of Embassy reporting, we estimate regulations curtailing the amount of money foreign workers were allowed to send out of the country caused about 200,000 of Iraq's 1.2 million foreign workers to leave, adversely affecting service industries and agriculture. 25X1 25X1 25X1

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The Debate Over Economic Policy in Iran

The proper role of government in an Islamic economy is perhaps the greatest source of disagreement among the factions competing for control of the Iranian revolution. In general, radicals in the regime favor a more centralized economy, while conservatives backed by the traditional economic power centers in the bazaar—merchant class—favor a system allowing more freedom to the private sector. Neither group appears to have the strength to impose its will. Ayatollah Khomeini, the only figure powerful enough to settle the disputes, has remained largely aloof from economic issues, occasionally putting forth vague and often contradictory pronouncements. The major issues include:

- *Land reform. Radicals see the issue as central to their aspirations for a just Islamic society and have sought the redistribution of all but the smallest farms. Conservative clerics—many of whom own large parcels of land—claim land reform proposals violate Islam's teaching regarding the sanctity of private property.*

- *Foreign trade. Radicals prefer government control and expansion of ties to Islamic trading partners. Conservatives wish to maintain close economic relations with the West and argue government interference has created bottlenecks and inefficiencies.*

- *Taxes. Radicals want a modern tax system that provides a reliable source of revenue and redistributes wealth. Conservatives believe only the traditional system of religious taxes paid directly to individual clerics is consonant with Islam.*

- *National ownership of industry. Radicals favor government ownership of most industrial enterprises. Conservatives strongly oppose government control of all but the largest industry on the grounds that it violates Islam's teachings on the right of private property and will lead to socialism.*

Economic Prospects for Iran

The foreign exchange crunch that plagued Iran's economy in 1986 is unlikely to show any improvement this year. Even under the most optimistic assumptions, Iran's foreign exchange problems will probably dictate little or no increase in imports. Under all but the most dire circumstances, we expect that Iran will prefer to impose additional austerity measures over borrowing large sums on international financial markets. We also expect political deadlock among factions about the proper role of government in an Islamic economy to hamper Tehran's ability to cope. Intensified Iraqi air attacks against economic targets also threaten to worsen Iran's economic problems. 25X1

Little Improvement in Finances

Although we believe that Iraq has the military capacity to halt practically all Iranian oil exports, Baghdad will most likely moderate its pressure to avoid Iranian reprisals. The sporadic nature of Iraqi attacks allows Iran to repair facilities and partly recoup lost exports during lulls. With only moderate Iraqi pressure through air attacks, we estimate Iranian oil exports in 1987 will average about 1.4 million b/d, somewhat less than in 1986. If Iraq carries out repeated, systematic attacks, we believe that Iranian oil exports would be kept to no more than 1 million b/d, as they were during the intensive air attacks in August-October 1986. With little or no Iraqi military pressure on Iran's oil exports or production, we believe Iran would produce slightly above its OPEC quota of 2.25 million b/d, implying exports of 1.6-1.7 million b/d. 25X1

We estimate Tehran's oil export revenues will be only slightly higher in 1987 than they were last year, assuming that oil prices average $15 per barrel for Iranian crude and exports average 1.4 million b/d. Under such circumstances, we expect imports will be about 20 percent lower than last year as Iran maintains the deep import cuts it started in the middle of 1986. Even if oil prices averaged $18 per barrel and export volumes were not affected by Iraqi attacks, we

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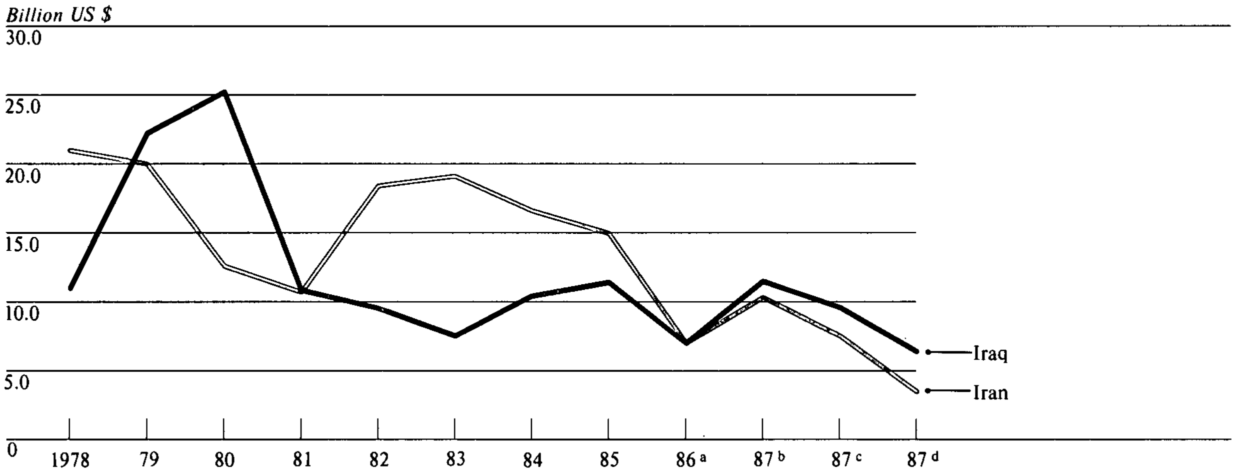
Figure 6
Iran-Iraq Oil Export Revenues, 1978-87



a Estimated.
b Oil price of $18 per barrel.
c Oil price of $15 per barrel.
d Oil price of $10 per barrel.

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expect Iran would only slightly relax import restraints. We believe that only a worst case scenario of very low oil prices—$10 or less—and/or strong Iraqi pressure on oil exports would force Tehran to make substantial cuts in imports of food, fuels, and medicine. Under such circumstances, Iran would probably try to obtain substantial foreign loans, although we believe most foreign governments or banks would be unwilling to advance large sums.

The promotion of nonoil exports is likely to have only minor near-term benefits for Tehran's financial position. For 1987 we estimate nonoil exports will rise by about 25 percent but will still account for less than 15 percent of total export revenues. Incentives for exporters remain weak because of the overvalued official exchange rate and government confiscation of earnings. About four-fifths of export revenues are turned over to the central bank, according to the regime's own data. Moreover, we believe that the government's policy of encouraging export of manufactured goods will generate little net revenue, as most industries are overwhelmingly dependent on foreign supplies of raw materials and machinery. 25X1

The cost of maintaining Syria's support and war-imposed transportation costs will be additional drains on Iran's revenues. We estimate that free oil provided to Syria will continue at 1986 levels of about 35,000 b/d worth about $190 million annually, based on an average price of $15 per barrel. We believe that the cost of Iran's oil shuttle, which includes maintenance, charter fees, and insurance, is at least $200 million a year. Moreover, Iraqi attacks on shipping in the southern Gulf have increased insurance and transportation costs on a large portion of Iran's imports. 25X1

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Figure 7
Iran-Iraq Nonoil Export Revenues, 1978-87

[a] Estimated.

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Iran will probably be forced to draw further on its foreign exchange reserves and increase its use of supplier credits, overdraft facilities, and other "low-profile" loans to cover a likely current account deficit. We believe, however, that Tehran will not deplete its reserves or acquire substantial loans to prop up import levels. Even if Tehran could obtain large foreign loans, its commitment to the goal of maintaining economic independence makes it unlikely they would be sought. [redacted]

Islamic precepts of thrift and the severe foreign exchange crisis following the revolution have made Iran extremely cautious regarding its foreign payments and assets. For example, Tehran in 1985 chose to increase its emergency foreign exchange reserves by cutting imports more than the amount necessary to balance its accounts, despite domestic pressures to maintain imports in the face of serious economic difficulties. [redacted]

[redacted] we estimate Iran began 1987 with $2-2.5 billion in readily accessible official cash reserves and $2.3-2.5 billion in gold, silver, and jewels. In addition, Tehran claims about $6 billion in less liquid assets, including those frozen in escrow accounts and uncollectable loans to less developed nations. [redacted] 25X1 25X1

Falling Living Standards

Iran will find it increasingly difficult to divert resources from the civilian sector to maintain its war effort. We estimate Iran spends about $4 billion annually in foreign exchange for military equipment and supplies. Iran made some cuts in food imports last year, but slack domestic production and pressure to maintain supplies to the lower class probably will prompt Tehran to import $2.5-3 billion in food, medicines, and agricultural inputs. Iran imported about $500 million in refined petroleum products in 25X1

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1986, and this could double in 1987 if Iraq intensifies attacks on refineries. Assuming oil exports of 1.4 million b/d at an average price of $15 per barrel, oil revenues this year will be approximately $7.7 billion—barely enough to cover requirements for food, fuel, and military supplies.

Given these circumstances, living standards in Iran will continue the downward trend of the past three years. On the basis of our middle estimate of oil production and prices, we estimate Iran's real per capita GNP will decline about 8 percent in 1987 following an estimated 16-percent decline in 1986. The fall in per capita GNP understates the impact on the average citizen, since an increasing proportion of domestic production is diverted to the military. High unemployment is likely to persist this year, although government unemployment benefits will limit the impact on those laid off. 25X1

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We believe that lower imports, declining domestic production, and competition by the military for scarce resources will drive up the inflation rate and worsen shortages of goods. We estimate inflation on the black market will be 20 to 25 percent in 1987, following a jump of at least 40 percent in 1986. Strong economic pressures will probably force the government to allow

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official prices to rise by about 15 percent following increases of only about 10 percent last year. Government efforts to regulate prices and contain inflation will worsen shortages. We believe that the increasing gap between official and black-market prices will divert more goods from official channels and inhibit productive investment.

Serious overcrowding in Iran's major cities, particularly Tehran, is accentuating the decline in living standards. The populations of Tehran and other major cities have more than doubled since the revolution. Crime and lack of social services characterize the sprawling ghettos thrown up on the outskirts of major cities. The Iranian press reports almost two-thirds of the families in these ghettos live in single, small rooms. The poor quality of housing helps explain Tehran's officially estimated 6,000 fires annually. The Iranian press also report on shortages and the decreasing quality of drinking water. 25X1 25X1

25X1

Economic Warfare

Iraqi air attacks on nonoil economic targets could prove to be the most damaging to the Iranian economy and living standards. The above estimates assume Iraq does not inflict substantial additional damage to Iran's domestic economic infrastructure. Even moderate damage will weaken the civilian economy as well

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Uncertainties and Assumptions Used in Economic Projections

The key unknowns affecting the economies of Iran and Iraq over the next year will be the oil market and the war. We believe that both Iran and Iraq will receive about $15 per barrel for their crude oil in 1987. Although prices will fluctuate, they are unlikely to exceed $18 or drop below $10 per barrel. Our oil revenue scenarios for each country are based on these high, medium, and low estimates. The intensity of the conflict on the frontlines and the level of economic warfare are more difficult to gauge. For our projections, we assume that Iran and Iraq will divert approximately the same resources to the war in 1987 as they did in 1986. Although Iran's economy is highly vulnerable to Iraqi military disruption, we do not believe Tehran's military has the ability to seriously damage Iraq's important economic facilities. Thus, our examination includes only the impact of Iraqi attacks on critical economic targets in Iran, especially the effects on Iranian oil production and exports. [redacted] 25X1

Iran and Iraq tightly guard economic information because they believe its release might help the other side in the war. [redacted] *Many of our economic and financial statistics for 1986 are estimates based on earlier years. These figures,* [redacted] *were used to make 1987 projections.* [redacted] 25X1 25X1 25X1 25X1 25X1 25X1 25X1

as hamper Iran's warmaking ability. Iran's supplies of refined oil and electric power will remain tight through 1987 even without additional Iraqi attacks. Baghdad demonstrated last year that it can disrupt transportation lines, basic manufacturing plants, and military industries. [redacted] some foreign firms have already curtailed operations because of increasing Iraqi attacks, reducing Iran's ability to repair damaged industries. [redacted] 25X1

Economic Policy Deadlock

In addition to external factors, we believe that the domestic political deadlock over economic policies is handicapping Iran's ability to cope with the effects of the war and the oil market. For example, Iranian leaders disagree over whether to continue pursuing a program of import substitution or adopt an export promotion campaign. Analysis of the Iranian press indicates that the sides of the debate fall along the same radical/conservative split that has hamstrung many economic policies since the revolution. Conservatives, backed by Western-trained economists, favor a free market approach that promotes nonoil exports and continuing trade with the West. Radicals worry that promoting exports encourages continued dependence on foreign trade and hurts the poor by building up private sources of wealth and power. Building domestic industries—albeit inefficient ones—to take over production of imported goods is linked by the radicals to the Islamic goal of the greatest possible reliance on domestically produced goods. [redacted] 25X1

We see little likelihood that Tehran's policy of maintaining fixed exchange rates, which vastly overvalues the Iranian rial, will be reversed any time soon. The political influence of Iran's bazaar (merchant) class as well as official corruption protect this policy, robbing the economy of productive capital investment and causing gross inefficiencies. An overvalued rial encourages imports, discourages exports, and channels capital into trading rather than domestic production. [redacted]

Political infighting and ineffective policies play havoc with the agricultural sector, which, according to the Iranian press, accounts for some 15 percent of GNP and as much as 40 percent of total employment. Inaction on land reform has led to competing claims over land ownership. The absence of guarantees regarding continued ownership or the transfer of land to heirs reduces investment incentives. Crop rotation is discouraged by Islamic laws that require one to use land or lose it. Food imports and consumer subsidies keep farm prices low and discourage greater production. [redacted] 25X1 25X1

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Table 1
Iran: Current Account Balance, 1984-87

Billion US $

	1984	1985	1986 [a]	1987 [b]	1987 [c]	1987 [d]
Trade balance	−0.90	2.32	−2.00	1.50	0.80	−2.25
Exports (f.o.b.)	17.10	15.62	8.00	11.50	8.70	4.65
Oil	16.80	15.15	7.20	10.50	7.70	3.65
Nonoil	0.30	0.47	0.80	1.00	1.00	1.00
Imports (c.i.f.)	18.00	13.30	10.00	10.00	7.90	6.90
Net services and transfers	−3.00	−1.50	−1.20	−1.00	−0.95	−0.90
Current account balance	−3.90	0.82	−3.20	0.50	−0.15	−3.15

[a] Estimated.
[b] Oil exports of 1.6 million b/d at $18 per barrel.
[c] Oil exports of 1.4 million b/d at $15 per barrel.
[d] Oil exports of 1 million b/d at $10 per barrel.

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We see little likelihood that Iran in the near term will sort out the government's role in industry. Currently most Iranian industry is nationalized, especially the modern sector. Factions in the leadership are at odds over whether to leave things as they are, to completely nationalize, or even to privatize industry. A maze of overlapping ministries and quasi-governmental organizations operate the extremely inefficient system. The failure of most national enterprises to turn a profit had given the privatization forces some momentum before the large fall in oil prices, but radicals have used current economic woes to justify greater central authority.

Economic Prospects for Iraq

We expect higher oil revenues, continued Arab aid, and better financial management to yield a slight improvement in the Iraqi economy in 1987. Baghdad's large foreign debts and continuing military expenditures, however, will remain a drag on economic performance and require continued austerity. We expect economic development efforts to remain stagnant while the regime uses any additional resources to purchase consumer goods. The willingness of foreign lenders to extend further trade credits to Iraq will be critical if Baghdad is to avoid further austerity measures. 25X1

Boost in Revenues

We estimate that increased oil exports and higher prices will raise oil export revenues in 1987 to about $9.6 billion, an increase of 35 percent from 1986. This assumes that Iraqi exports average 1.7-1.8 million barrels per day at $15 per barrel. We expect the boost in oil exports from 1986 will come from a 500,000-b/d expansion of Iraq's 1-million-b/d pipeline through Turkey, likely to be completed this fall. In addition, despite Saudi Arabia's reluctance to allow more oil onto the world market, the US Embassy in Baghdad reports that Riyadh in March allowed Iraq to increase exports to near capacity through the 500,000-b/d Iraqi-Saudi Spurline. The Saudis, citing technical difficulties, had restricted Iraqi exports through the line to about 200,000 b/d—slightly less than two-thirds of the 1986 average—between November 1986 and February 1987. 25X1

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Saudi Arabia and Kuwait: Iraq's Financial Backers

Since the start of the war, Arab financial aid to Iraq has totaled about $33 billion. About $27 billion has been given by Saudi Arabia and Kuwait. Financial aid to Baghdad probably totaled about $2.3 billion in 1986. The aid takes several forms:

- Neutral Zone oil sales on Iraq's behalf. *Under an agreement signed in 1983, Saudi Arabia and Kuwait sell about 240,000 b/d of oil from the Saudi-Kuwaiti Neutral Zone and give the proceeds to Iraq monthly. Sales, however, were below the contracted amount for the first half of 1986 because of the weak oil market. This aid totaled about $800 million last year.*

- Saudi oil sales on Iraq's behalf. *Saudi Arabia sold an average of 60,000 b/d of its own oil for Iraq last year, totaling about $250 million. Almost all of this oil was provided to the Soviet Union to pay for military purchases by Baghdad.*

- Cash payments. *Cash payments to Baghdad in 1986 were about $1 billion, almost entirely from Saudi Arabia.*

- Paying directly for arms purchases by Iraq. *Saudi Arabia has paid with cash or oil for some weapon shipments to Iraq by France. We believe Riyadh and Kuwait have also paid Egypt for some arms sales to Baghdad. This aid probably totaled at least $200 million in 1986.*

- Supply of military equipment. *Saudi Arabia and Kuwait provide Baghdad with small amounts of munitions out of their stocks including cluster bombs and FROG missiles. Both countries also serve as transshipment points for Iraqi military and economic supplies.*

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We believe financial aid from Saudi Arabia and Kuwait in 1987 will total $2-2.5 billion, depending in large part on the level of fighting. Riyadh has generally made substantial cash payments to Baghdad in response to large Iranian offensives. Oil sales on Iraq's behalf—or their cash equivalent—probably will continue at their present level of about 300,000 b/d at least until the second Iraq-Turkey pipeline starts operation. According to the US Embassy in Kuwait, Kuwait is considering reducing oil sales on Iraq's behalf once the Turkish line opens. Saudi Arabia and Kuwait continue to support Iraq's war effort despite repeated warnings from Tehran to cease their assistance. Recent stinting on aid, however, suggests that both countries will seek to limit their financial burden by offering only enough aid to keep Iraq fighting. Hence, we believe their aid to Iraq will be sufficient to sustain essential military and consumer imports but not to prop up living standards. 25X1

We believe that Iraq will boost its nonoil exports by one-third in 1987 to about $600 million, mostly from higher natural gas sales to Kuwait. Nonoil exports in 1986—predominantly dates, fruits and vegetables, natural gas, and industrial products—totaled nearly $450 million, about 6 percent of total export revenues. Kuwait last year financed the construction of a gas export pipeline from Iraq's Ar Rumaylah oilfield to Kuwait's Shuaiba industrial area. Baghdad—which is exporting 200 million cubic feet per day through the line—plans this year to double natural gas exports and begin exporting about 40,000 b/d of petroleum products through a parallel line. 25X1

Managing Finances

More careful management of its finances, continued austerity, and higher oil revenues are likely to improve Iraq's ability to cope with its foreign debts this year. The sense of confusion that guided Iraqi financial

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Table 2
Iraq: Major 1986 Debt Rescheduling Agreements and Repayment Schedule, 1987-92

Million US $

	Amount Rescheduled	Amount Repaid in Oil	Amount Due					
			1987	1988	1989	1990	1991	1992
Total	**6,240**	**1,140**	**310**	**2,090**	**1,044**	**538**	**208**	**208**
France	400	0	0	120	200	80	0	0
French banks	400	0	0	0	57	114	114	114
West Germany	580	0	0	290	290	0	0	0
Japan	300	0	0	100	200	0	0	0
Japanese banks	330	0	0	0	47	94	94	94
Italy	680	180	0	167	167	167	0	0
Turkey	1,200	540	310	350	0	0	0	0
India	200	120	0	80	0	0	0	0
South Korea	250	0	0	83	83	83	0	0
Yugoslavia	1,200	300	0	900	0	0	0	0
China [a]	700							

[a] Repayment schedule unknown.

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dealings for most of 1986 has been replaced, in our view, by a more orderly approach. According to the US Embassy in Baghdad, Iraq is sorting out its foreign debt priorities and repaying some overdue letters of credit and other obligations.

We, nonetheless, expect Iraq's finances to remain tight in 1987. Although higher export revenues probably will relieve some of the financial pressure, Baghdad will still face a $3.85 billion shortfall in foreign exchange in 1987. To finance this deficit, the regime probably will continue to limit civilian expenditures while seeking additional debt reschedulings and new foreign credits. To improve its cash position, Baghdad has sold several hundred million dollars' worth of its gold reserves since the middle of last year. The gold sales probably increased Iraq's liquid foreign exchange reserves to about $1.3 billion as of January 1987. The balance of Baghdad's foreign assets—about $1-1.5 billion—is mostly uncollectible loans to Third World nations.

We believe Iraq will be able to reschedule a large portion of its medium- and long-term civilian debt due in 1987. Baghdad has already rescheduled some commercial and official debt due this year and is still trying to reschedule overdue 1986 payments. On the basis of Embassy and press reports, we estimate that about $4 billion in civilian principal payments and $1.5 billion in interest payments are due in 1987. Although Iraq probably would benefit from a multilateral rescheduling with its major creditors, Baghdad is likely to avoid such an action, seeing this as public admission that its debt burden is unmanageable.

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Amount of Foreign Financing Is Crucial

The amount of foreign credits Iraq receives this year will largely determine its ability to avoid further austerity measures. Despite recent debt repayments, many of Iraq's creditors remain cautious about lending additional funds. For example, the Embassy

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Table 3
Iraq: Current Account Balance, 1984-87

Billion US $

	1984	1985	1986 [a]	1987 [b c]	1987 [b d]	1987 [b e]
Trade balance	−1.65	−0.80	−2.55	2.60	0.70	−2.50
Exports (f.o.b.)	10.65	11.70	7.45	12.10	10.20	7.00
Oil	10.40	11.40	7.00	11.50	9.60	6.40
Nonoil	0.25	0.30	0.45	0.60	0.60	0.60
Imports (c.i.f.)	12.30	12.50	10.00	9.50	9.50	9.50
Net services and transfers	−2.90	−3.35	−2.70	−2.80	−2.80	−2.80
Current account balance	−4.55	−4.15	−5.25	−0.20	−2.10	−5.30
Arab financial aid	3.60	2.50	2.30	2.30	2.30	2.30

[a] Estimated.
[b] 1987 oil revenue scenarios are based on average oil exports of 1.75 million barrels per day.
[c] Oil price of $18 per barrel.
[d] Oil price of $15 per barrel.
[e] Oil price of $10 per barrel.

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reports that France, West Germany, and Austria have indicated they are willing to make new loans only if Baghdad repays additional overdue letters of credit. Many West European banks are extremely reluctant to confirm Iraqi letters of credit, and the ones that do are charging Baghdad high interest rates. According to press reports, the export credit agencies of Italy and Japan—major trading partners—continue to reduce their lending exposure to Baghdad.

Despite these problems, we believe Iraq will receive sufficient credit to ensure essential consumer imports such as food and medicines. The United Kingdom and the US Commodity Credit Corporation continue to extend credit because of Baghdad's prompt repayment record on previous loans. According to press reports, the United Kingdom agreed last November to roll over into 1987 about $300 million in unused credits to finance the purchase of British pharmaceuticals, medical supplies, and capital equipment by Iraq. The US Commodity Credit Corporation will guarantee payment on up to $700 million in loans to finance agricultural exports to Iraq—up from about $600 million last year. Turkey—an important foodstuffs supplier to Iraq—allows Baghdad 18 to 24 months to pay for Turkish goods, according to press reports.

Impact of Spending Cuts on Industry and Development

President Saddam Husayn is taking a direct role in reorganizing Iraqi industry to cope with budget cutbacks. According to the US Embassy in Baghdad, Saddam—during several meetings in February of the Revolutionary Command Council—criticized economic officials and warned them that their ministries will have to get by on less money. The regime hopes to boost industrial productivity and output by reducing excessive government regulations and supervision and offering greater incentives to workers. 25X1 25X1

Although the proposed changes should improve efficiency, Iraqi industry and development plans are heavily dependent on imported materials and machinery, and the large cuts being made probably will further curtail economic activity and the availability of domestically produced goods. US Embassy reporting indicates there are plans for further reductions in spending for the industrial sector, which will reduce supplies of some consumer items, such as soap, and hurt domestic construction and employment. 25X1

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Figure 10. Iraqi President Saddam Husayn meets with top Iraqi economic officials to discuss ways of increasing industrial production.

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We believe that Baghdad will be forced to concentrate its development efforts on a few selected petroleum, petrochemical, agricultural, and power plant projects. Despite recent public statements by First Deputy Prime Minister Ramadan that Iraq will revive its large-scale development plans, we believe the program will continue to be hampered by Iraq's inability to convince most contractors—already stung by missed payments—to cut costs and offer more attractive financing. According to press reports, Baghdad is asking many contractors to reduce costs by at least 20 percent, provide 100-percent financing in foreign exchange, and accept a larger proportion of repayment in Iraqi dinars. Basic infrastructure probably will deteriorate as development projects take a backseat to more immediate needs. Several water supply, sewerage, and transportation projects already are being shelved, according to press reports.

We expect expansion of oil export capacity and oilfield development to continue to receive top priority despite financial difficulties. Oilfield development will most likely center on the West Qurnah and Ar Rumaylah oilfields—with Soviet financial and technical assistance.

Labor Shortages Aggravated

The continuing manpower drain of the war and the exodus of foreign workers because of payments problems will further aggravate Iraq's labor shortage. On the basis of Embassy reporting, we estimate that restrictions on foreign remittances and cutbacks in development spending will reduce the number of foreign workers in Iraq to some 900,000 from about 1.2 million at the end of 1985. The loss of about 200,000 Egyptians will hinder efforts to improve agricultural production, disrupt some retail services, and contribute to the closing of some factories. The US Embassy in Baghdad reports that Saddam's insistence that all Iraqis participate directly in the war effort is worsening shortages of skilled technicians in the petroleum, banking, and power generation industries. 25X1

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Prospects for the Populace

We believe that Iraqis will see little improvement in living standards during 1987. Iraq delayed significant spending cuts until the second half of 1986, and the regime probably will continue austerity measures for most of 1987. According to the US Embassy in

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Table 4
Iraq: Foreign Payments, 1987

Billion US $

Foreign exchange requirements	16.35
Food and agricultural imports	2.00
Nonfood civilian imports	3.00
Military imports	4.50
Principal payments due on foreign debt	4.00
Interest payments due on foreign debt	1.50
Invisibles [a]	1.35
Foreign exchange revenues	12.50
Oil exports	9.60
Nonoil exports	0.60
Arab financial aid	2.30
Financial gap	3.85

[a] Includes foreign worker remittances and oil pipeline transit fees.

[redacted]

Baghdad, Saddam's reorganization of government-owned industries includes reducing benefits to blue-collar workers. We believe further cuts in civilian imports are being made. The regime may be encouraged to relax spending restrictions toward the end of the year, although this will largely depend on the amount of foreign trade credits Baghdad obtains. [redacted]

War spending will continue to drain resources from the civilian economy. In a public statement last December on the 1987 budget, First Deputy Ramadan said funding of the war would remain the first priority. We estimate that the foreign exchange cost of the war in 1986 averaged about $375 million per month, or $4.5 billion for the year. In contrast, on the basis of Iraqi and OECD trade statistics, we estimate that Iraq imported about $2-2.5 billion of food—mainly wheat, rice, meat, and dairy products—and agricultural raw materials in 1986. The regime's tight foreign exchange position will be helped somewhat by an above-average 1986 grain harvest—reported by the US Embassy in Baghdad—that probably will allow Baghdad to trim food imports slightly this year. [redacted]

High prices, shortages of many items, and reduced government benefits are likely to continue for most of 1987. Although the 1987 civilian import plan gives top priority to the provision of essential consumer items, the availability of many goods will fluctuate. According to press reports, the regime may be stockpiling food to alleviate future shortages. The US Embassy in Baghdad reports that lines form daily for chickens, eggs, and laundry detergent. Shortages of meat probably will increase over the next several months, but supplies of vegetables, rice, sugar, and cooking oil should improve, according to the Embassy. Difficulties in the distribution of goods, including food—along with the growing diversion of many items into the black market—are likely to add to the uncertain supply situation. Shortages probably will drive inflation to 20 to 25 percent during 1987, from about 15 percent in 1986. [redacted] 25X1

We believe that Baghdad has been largely successful in its efforts to convince Iraqis that they must accept more sacrifices because of the war and low oil prices. The Iraqi leadership probably was disappointed by failed expectations in 1986—the regime had hoped that anticipated higher oil revenues from the Iraqi-Saudi Spurline would allow it to reward the populace for past sacrifices—and now seems to have a more realistic outlook. According to the US Embassy in Baghdad, Iraq is basing its 1987 import plan on a $15-per-barrel oil price, and contingency plans are using a $12-per-barrel price. [redacted] 25X1 25X1 25X1

Political and Military Implications

Political Stability in Iran

Over the next year, Tehran is likely to become increasingly concerned about the impact of the weakening economy on political stability. Even the most favorable oil price scenarios indicate that Iranian oil revenues will be too low to permit a reversal of its foreign exchange difficulties. [redacted] 25X1 25X1

[redacted] the population's negative response to fuel 25X1

25X1

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Figure 11
Iraqi Oil Export Pipelines

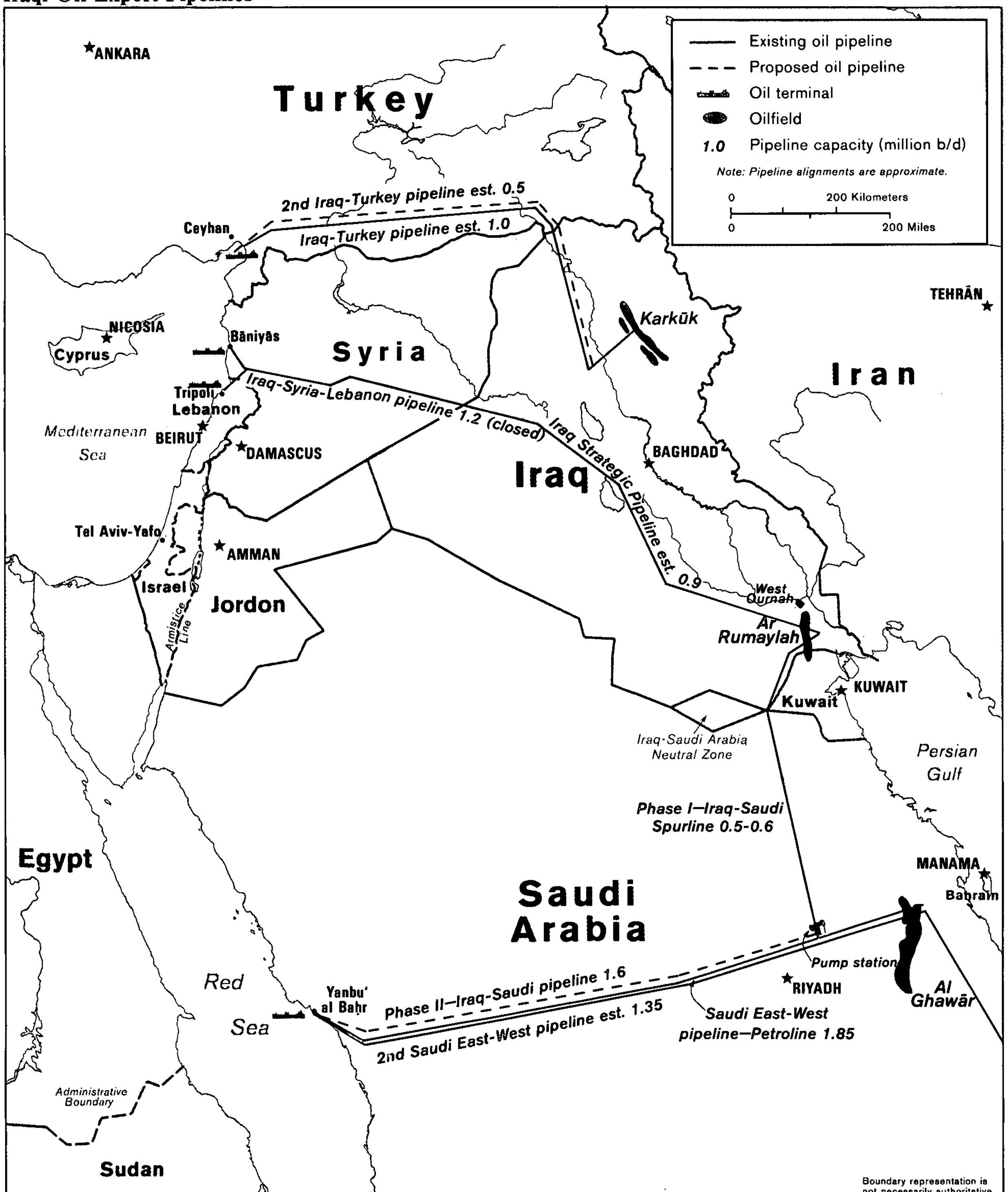

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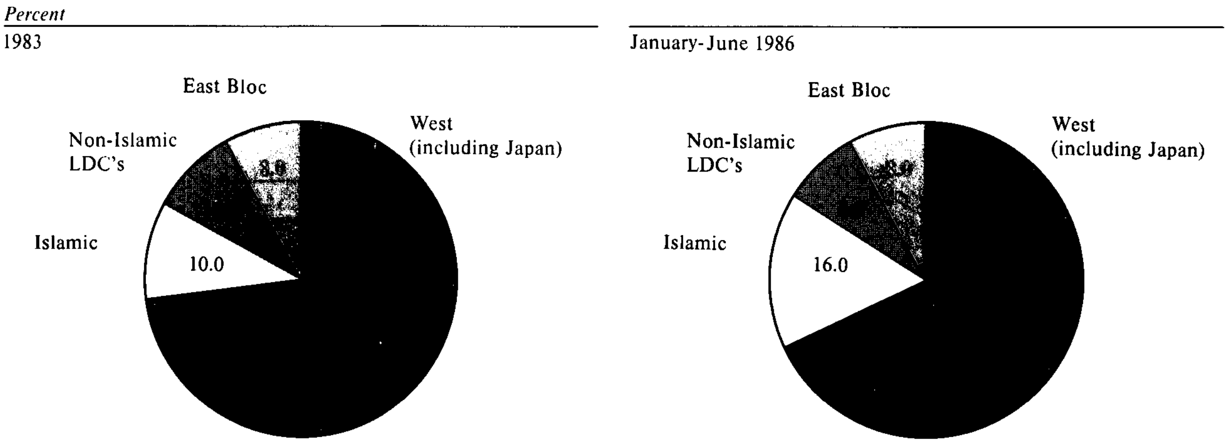
Figure 12
Iran: Share of Foreign Trade, 1983 and January-June 1986



Source: Iranian Ministry of Commerce.

[redacted] 312350 4-87 25X1

rationing last fall was swift and widespread, pointing up the tenuous nature of day-to-day life in Iran. [redacted]

Government services and the rationing system are crucial pillars of the regime that may be in danger over the coming year. In its budget for 1987 the regime pledged to maintain food subsidies and other welfare programs, but this appears impossible given insufficient oil and tax revenues. [redacted] the populace is losing faith in clerical management of the rationing and distribution systems. Late last year Iranian newspapers became far more strident in their criticism of economic management, which is widely viewed as overcentralized and corrupt. [redacted]

Radicals and conservatives are also struggling to blame each other for current difficulties. Radicals have picked on their favorite economic villains, the bazaaris and the middle class. Radical newspapers have already called for confiscating the wealth of the bazaaris and other capitalists. Conservative newspapers have scorned the economic policies of the radical Prime Minister Musavi. Indeed, the government appears to be increasingly sensitive to internal criticism of the economy, an issue that the regime has generally allowed to be discussed relatively freely. In late 1986 the Commerce Minister blamed internal enemies for distributing "secret" economic information. [redacted]

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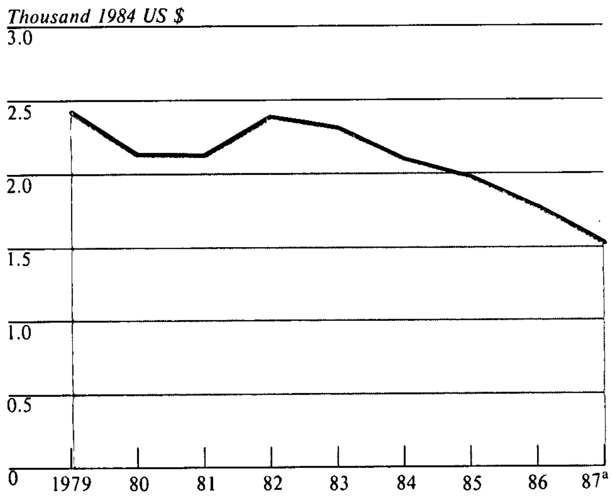
Political Stability in Iraq

We do not believe that economic austerity alone will threaten Saddam Husayn's hold on power in 1987. Although the regime probably is wary of imposing additional economic hardships on the Iraqi people, unrest is more likely to be generated by Iraq's military setbacks—especially large numbers of casualties. In any event, Iraqi security forces remain ruthless in their efforts to suppress antiregime elements. According to press reports, Iraq's ruling Ba'th Party late last

Figure 13
Iran: Real Gross Domestic Product (per capita), 1979-87



[a] Estimated.

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year gave notice that severe penalties would be imposed for criticism of the government, including the death penalty for a public insult of President Saddam Husayn, the National Assembly, or the Revolutionary Command Council, according to press reports.

The War

We believe that changes in economic conditions over the next year—somewhat higher oil prices, higher oil exports by Baghdad, and economic warfare—will favor Iraq, although we do not expect Iraq to gain the initiative in the war or Iran to call an end to the fighting in 1987. We expect this trend to improve Iraq's ability to maintain forces sufficient to hold off the Iranians. Iran, on the other hand, will find it increasingly difficult to afford lengthy offensives like the Al Basrah campaign. Insufficient oil revenues will also hamper replenishment of its military arsenal after major ground offensives.

We believe that Iran's success near Al Basrah has made Tehran more determined to continue its military efforts to overthrow Iraq's Ba'thist regime, despite financial difficulties. The Iranian ground attacks near Al Basrah represented a victory for those in Tehran who have pressed for forceful execution of the war, including Majles Speaker Rafsanjani, who has played a prominent role in directing an aggressive war strategy. Iran's severe economic problems in the latter half of 1986 and fear of military failure had prompted some in Iran's leadership to counsel against further major offensives in favor of redirecting resources to the civilian economy. 25X1

Iraq's cash squeeze is unlikely to reduce its ability to prosecute the war, despite growing difficulties in financing military purchases. Saudi and Kuwaiti financial support will provide for urgent military requirements. The USSR and France are likely to continue delivery of essential weapons despite Iraq's payment problems, especially if the threat of an Iranian victory grows. The delivery of MIG-29s to Iraq along with other military supplies over the past several months suggests Moscow's continued commitment to Baghdad. 25X1

Baghdad is likely to maintain the tempo of its air attacks on Iran's economic infrastructure with pauses during major Iranian offensives. The Iraqis have the capability to mount an air campaign that would bring Iran's economy, particularly the urban-based economy, to a halt. A sustained campaign could prompt Tehran to wind down the war. Tehran is unlikely under any conditions to accept peace on Baghdad's terms. Nonetheless, we believe Iraq will continue to inflict only moderate damage on Iranian industrial targets, modulating its efforts carefully to avoid drastic Iranian reprisals against Baghdad or its Arab allies. 25X1 25X1 25X1

We believe that Iran will react to Iraqi economic pressure by launching sporadic air and missile attacks inside Iraq and by using force to get the Gulf states—primarily Saudi Arabia and Kuwait—to reduce support for Baghdad. Iranian rocket attacks in March

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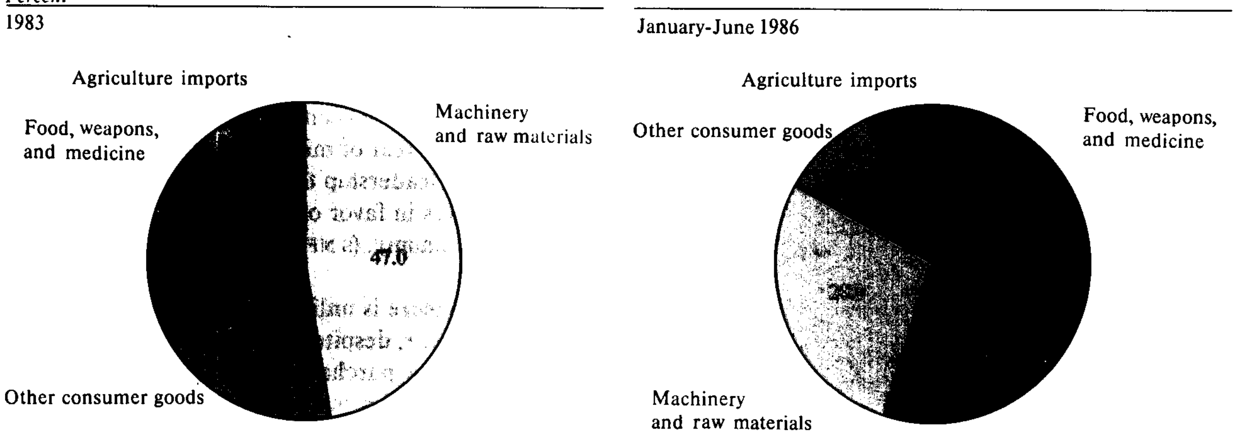
Figure 14
Iran: Composition of Imports, 1983 and January-June 1986[a]

Percent



[a] Many goods in categories other than weapons probably go into the military effort, such as machinery for military industries.

Source: Iranian Ministry of Commerce.

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against two Saudi oil tankers—the first such attacks since May 1986—indicate Tehran is willing to use force against Riyadh despite increased contacts over the past year. Moreover, Iran has increased its capability to hit shipping in the Gulf by obtaining Silkworm missiles from China. At a minimum, Iran probably will maintain a level of shipping attacks similar to 1986, focusing on ships using Kuwaiti ports. The regime probably also will again sponsor terrorism against Gulf oil facilities and presumably has contingency plans for airstrikes or commando raids if Tehran is strongly pressed by Iraq.

Relations Within OPEC

The opposing oil policies of the combatants—Iraq's drive to increase oil exports and Iran's desire to hold down OPEC production—are likely to heighten tension among Persian Gulf oil producers. Iran, with little military capability to force a reduction in Iraqi oil exports, will seek to exert indirect pressure on Baghdad by threatening states in the Gulf. In particular, Tehran probably will intensify pressure on Saudi Arabia to reduce Iraqi oil exports through the Iraqi-Saudi pipeline and Saudi oil sales on Iraq's behalf. Iran will continue to encourage the Saudis and other OPEC members to hold oil production down and charge official prices. Should Saudi Arabia—either because of weakening oil demand or widespread cheating by other OPEC members—again pursue an oil strategy that drives down prices, Iran is likely to intensify attacks on ships using Saudi ports.

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OPEC may be pressed by a fragile oil market and a bellicose Iran to go beyond informal criticism—possibly including public censure—of Baghdad when Iraq opens its 500,000-b/d pipeline through Turkey this fall. The opening of this line will be a major test of OPEC's ability to maintain higher prices and will

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Impact on Major Trading Partners

Japan, West Germany, the United Kingdom, Italy, and France together accounted for about half of all imports into Iran and Iraq in 1985, according to international trade statistics. Import cuts imposed by Iran and Iraq cut exports from these major trading partners by about 30 percent in the third quarter of 1986, as compared with the third quarter of 1985. Because trade with Iran and Iraq represents only a tiny fraction of total trade by these large economies, this decline has had little general effect on exporters. Individual companies in these countries, however, have suffered because of payment delays, particularly in Iraq. For example, West German officials have told the US Embassy that several small German contractors face bankruptcy because of Iraq's failure to pay on time. The presence of foreign firms in Iran and Iraq either through involvement in development projects or local trade has fallen significantly during the past few years. Recent austerity measures in both countries have accelerated this process.

further aggravate Iraq's relations within OPEC—already strained by Baghdad's refusal in December 1986 to accept its OPEC-assigned 1.46-million-b/d quota. Baghdad's insistence on a quota equal to Iran's—2.25 million b/d—has drawn increasing criticism from other members. According to the US Embassy in Kuwait, Iranian efforts to suspend Iraq from OPEC last December, although prohibited by OPEC's constitution, were nonetheless sympathetically received by the majority of OPEC members. 25X1

We believe that differences over oil policy will continue to be a source of friction between Iraq and Saudi Arabia. Saudi King Fahd—in contrast to his earlier support for Iraq's position—now believes that Baghdad should do more to support the OPEC accord. The Saudis are pressing Baghdad to limit oil production, and Riyadh dragged its feet for nearly two months before allowing Iraq to increase oil exports through the Iraqi-Saudi Spurline. Saudi Arabia will probably limit the impact on the market of increased Iraqi production by making some reductions in oil produced on Iraq's behalf. Riyadh is likely to compensate any such reductions with increased cash assistance. 25X1

Implications for the United States

We see a danger that growing economic problems will encourage Tehran to turn to the Soviet Union for economic support. The meeting in December 1986 of the Iran-Soviet Joint Economic Commission is an indication of Tehran's desire to expand cooperation in a variety of economic areas. The USSR is ideally positioned to buy political concessions with technical assistance or supplies of food, electricity, and fuel. So far, however, Tehran has firmly resisted Soviet efforts to use trade relations as a lever to soften Iranian foreign policies toward Moscow 25X1

Iran's economic problems are also encouraging Tehran to seek better trade relations with the West, including willingness to trade with US firms. These 25X1 moves, however, almost certainly do not represent a desire for significantly improved political relations with the United States. Iran 25X1 has appeared more willing than previously to approach US firms, particularly oil companies, to rebuild damaged oil facilities, 25X1
Iran has been willing to soften regulations 25X1 against dealing with US firms. 25X1
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The Soviet Union's apparent willingness to offer attractive financing terms and its leverage as Baghdad's principal arms supplier may enable Moscow to increase its already large participation in Iraq's oil

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industry. [redacted] Moscow said it was willing to sell Baghdad oilfield equipment with two- and even five-year deferred payment financing. Moscow and Iraq signed a two-year agreement in December to cooperate in oil development and refining, according to press reports. Iraq's desire to forge ahead with development of its oil industry probably is making Baghdad more willing to accept additional Soviet assistance despite dissatisfaction with Soviet equipment. [redacted]

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We believe that US-Iraqi political and trade relations, which have suffered from revelations of the US initiative toward Iran and other issues, will at best improve slowly. The US Export-Import Bank's refusal to extend credit in 1986 prompted Iraq's Minister of Trade to cancel a scheduled trip to the United States last July and to refuse to sign an agreement to set up a joint commission on bilateral trade. Baghdad, however, is giving high priority to US firms in debt repayments, hoping that the Export-Import Bank eventually will lend Iraq new funds. Baghdad's preference for US equipment and technology as well as the need for political support against Iran will help keep relations on a businesslike basis. [redacted]

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